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POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON DC 20268-0001

POSTAL RATE AND FEE CHANGES, 2000

Docket No. R2000-1

REBUTTAL TESTIMONY OF
RICHARD J. STRASSER, JR.
ON BEHALF OF
THE UNITED STATES POSTAL SERVICE

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Direct Testimony
of
Richard J. Strasser Jr.
AUTOBIOGRAPHICAL SKETCH

1

2 My name is Richard J. Strasser, Jr. I am Acting Chief Financial Officer and
3 Executive Vice President of the United States Postal Service. I was appointed to
4 this position on May 3, 2000, after serving as District Manager, Northern Virginia,
5 since 1992.

6 While serving as District Manager, I led a team that continually improved
7 service in Northern Virginia, while satisfying growing customer demands fueled
8 by rapid commercial development and residential growth. Prior to this field
9 assignment, I served as Chief Marketing Officer and Chief Planning Officer. My
10 postal career began as a management intern in 1969. Before becoming an
11 officer, I held progressively responsible management positions, including the first
12 product manager for Express Mail.

13 I graduated from Seton Hall University with a BA in political science and
14 accounting. I also received a Master's degree in Public Administration through
15 the Key Executive program at American University. I attended executive
16 programs at the University of Virginia's Darden School and at Duke University's
17 Fuqua School of Management. I have lectured extensively on the topic of
18 government-sponsored enterprises.

1 I. PURPOSE AND SCOPE OF TESTIMONY

2
3 My testimony responds to and rebuts intervenors who propose reducing
4 the Postal Service's revenue requirement for the Test Year. In the following, I
5 demonstrate that neither their testimony nor post-filing events form a legitimate
6 basis for the proposed reductions. In particular, several intervenor witnesses
7 urge the Postal Rate Commission to override management's discretion and
8 reduce the Postal Service's contingency from 2.5 percent to 1.0 percent. I will
9 reaffirm that, contrary to these intervenors' testimonies, in the circumstances of
10 the Docket No. R2000-1 rate case, the 2.5 percent provision for contingencies is
11 not only reasonable, it is responsible and conservative.

12 In connection with my discussion of the proposed revenue requirement
13 reductions, I will also briefly review the major implications of the updates to the
14 Postal Service's test year estimates that resulted from Commission Order No.
15 1294 and related rulings and requests for information. These updated estimates
16 are contained in witness Patelunas's supplemental testimony, numerous library
17 references, and in Postal Service responses to various inquiries from
18 intervenors, the Presiding Officer, and the Commission. The Postal Service
19 does not believe that it would be appropriate to supplant the financial foundation
20 for its filing with a reformulated base year and completely revised test year
21 estimates. Accordingly, it has not proposed amending its Request for new
22 revenues as a result of the updates. I must emphasize, however, that any
23 attempt to update the Postal Service's revenue needs in the test year should at a
24 minimum take account of the assumptions and adjustments presented in Mr.
25 Patelunas's testimony.

26 Four other Postal Service witnesses present rebuttal or supplemental
27 testimony related to the revenue requirement. Witness Zarnowitz (USPS-RT-2)
28 explains that the business cycle is not dead and outlines the substantial
29 uncertainty and inflationary pressures we face in today's economic environment.
30 Witness Thress (USPS-ST-46) shows that interim period volume projections

1 have tracked well with actual results. This renders it unlikely that we will be
2 "bailed out" by higher than projected volumes and revenues in the test year.
3 Witness Dowling, in response to ANM witness Haldi, explains how the Postal
4 Service has responsibly pursued opportunities to develop and implement
5 technology to reduce flat processing costs. My testimony also responds to
6 witness Haldi and shows why Haldi's productivity adjustment should not be
7 made. Finally, witness Patelunas's rebuttal testimony addresses DMA et. al.
8 witness Buc's efforts to increase the Postal Service's already substantial cost
9 savings program estimates. My testimony responds to witness Buc's testimony
10 on issues relating to the contingency.

11
12 II. THE POSTAL SERVICE'S PROPOSED CONTINGENCY PROVISION
13 FALLS WELL WITHIN A WELL-ESTABLISHED RANGE OF
14 REASONABLENESS
15

16 Several intervenors have argued that the Postal Service does not need a
17 2.5 percent contingency, because it has operated successfully over the last two
18 rate cycles with lower contingency provisions. In so arguing, however, they have
19 not recognized the increased risk that now characterizes the time period through
20 the test year. They have also argued that the Postal Service has not adequately
21 supported its contingency provision, and has not followed the approach for
22 justifying the contingency established by the Commission in its prior Opinions.
23 For example, Witness Buc makes the extreme claim that the Postal Service has
24 never in the history of postal ratemaking developed a reasoned contingency
25 provision. Tr. 22/9563.

26 On the contrary, the Postal Service has rationally reckoned its
27 contingencies from rate case to rate case, pursuant to a judgmental assessment
28 of the need for a cushion against unknown developments in the test year. This
29 assessment appropriately takes account of a variety of factors, including the
30 Postal Service's expected financial condition, historical experience, the potential

1 for unknown future adversities, and the Postal Service's financial, operational,
2 and ratemaking policies.

3 By contrast, intervenors have argued that the contingency must be
4 justified largely empirically, with statistics and hard data, such as a historical
5 variance or probability analyses. As the Postal Service has long maintained,
6 however, while historical and forecasted quantitative data can clearly aid the
7 decision-making process, the ultimate decision to include a provision for
8 contingencies is logically and necessarily judgmental, and represents a major
9 policy choice by the Board of Governors as to the level of risk the Postal Service
10 is willing to assume in the test year with regard to unknown developments. In
11 this regard, it seems ironic that each intervenor witness who insists that
12 judgment should not be the basis for determining the contingency has in fact
13 used the very approach he has argued against. Each of them has considered
14 historical data, examined forecasts and trends related to the future, and then
15 judgmentally determined that a lower contingency is warranted based on the
16 facts they have considered. This is the same process the Postal Service
17 followed.

18 Selection of an appropriate provision for contingencies has always been
19 an integral part of a responsibly-developed revenue requirement. Congress
20 expected that the Postal Service would include a contingency amount in
21 estimating its future revenue needs. Section 3621 of the Postal Reorganization
22 Act (39 U.S.C. § 3621) provides that :

23 Postal rates and fees shall provide sufficient revenue so that total
24 estimated income and appropriations to the Postal Service will
25 equal as nearly as practicable total estimated costs of the Postal
26 Service. For the purposes of this section, "total estimated costs"
27 shall include (without limitation)...a reasonable provision for
28 contingencies.

29
30 The Kappel Commission, furthermore, suggested 3.0 to 5.0 percent as a
31 reasonable range. Over the course of 30 years of postal ratemaking, the Postal

1 Rate Commission has recommended all but one of the Postal Service's
2 contingency requests, which have ranged between 1.0 and 5.0 percent.¹

3 The intervenors emphasize that in Docket Nos. R94-1 and R97-1, the
4 Postal Service included relatively low provisions for contingencies (2.0 and 1.0
5 percent, respectively), compared to the historical pattern of from 3.0 to 5.0
6 percent. As explained by Witness Tayman, however, the situations justifying the
7 Postal Service's judgment in those cases, were unique. The Postal Service's
8 financial performance has since become more marginal, and new uncertainties
9 are emerging. Consequently, the Postal Service has restored the contingency to
10 a more normal, but still modest level of 2.5 percent. In fact, the predicate for
11 returning the level of the contingency provision in this case closer to the historical
12 norm was laid by Witness Tayman in Docket No. R97-1, when he testified
13 concerning the 1.0 percent contingency provision in that case. He stated,

14 This conclusion does not represent a permanent change
15 in management's judgment concerning the level of
16 coverage generally necessary to protect against
17 unforeseen events and forecasting errors. In different
18 circumstances in the future, it may well be necessary to
19 return to the higher levels of contingency historically
20 deemed prudent to provide the protection intended by the
21 provision for contingencies.

22
23 USPS-T-9, p. 38, Docket No. R97-1.

24
25 Intervenors attacking the contingency, exemplified by OCA witness
26 Rosenberg, refuse to acknowledge that current circumstances are different. See
27 Tr. 22/9852 and Tr. 22/9875-78. Fiscal Year 2000, however, which is an interim
28 year in this rate filing, has been one of the most challenging years for Postal

¹ Docket No. R80-1 was the lone instance where the Commission recommended reducing the contingency provision. An appellate court overruled, as an "unlawful intrusion into the policy-making domain of the Board," the Commission's recommendation that the Postal Service's 3.0 percent contingency provision in that docket be reduced to 1.8 percent.

1 Service managers in recent memory. Fiscal Year 2001 (the Test Year) promises
2 to be even more challenging.

3 In this regard, there is absolutely no reason to reduce the proposed
4 contingency in response to OCA Witness Burns' unfounded concern that the
5 contingency constructs a "moral hazard for lax and inefficient management" (See
6 Tr. 22/9775), or Witness Rosenberg's fear that the contingency provision
7 provides a cushion that results "in a tendency toward slackness." See. Tr.
8 22/9826. As a field District Manager, I take must emphatically take exception to
9 these suggestions. Postal managers and craft employees are concerned about
10 our customers and the future of our business and *do not* behave in this manner.
11 Extraordinary efforts have been made by dedicated managers and employees
12 working to achieve the \$100 million net income goal set forth for FY 2000.
13 There have been continuing field and headquarters operating budget cuts
14 throughout this year.

15 Despite these efforts, it has appeared less and less likely as this year
16 progresses that we will actually achieve a positive net income. Through
17 Accounting Period 11, we are \$436 million behind our \$100 million FY 2000 net
18 income plan. This level of financial performance is dramatically different from the
19 circumstances that prevailed in Docket No. R97-1, where we earned a
20 substantial positive net income in the interim year, and had been consistently
21 performing well ahead of plan.

22 Without exhaustively listing all differences in the financial and operating
23 environment since the last rate case, I believe it is clear that inflation has already
24 accelerated beyond what was embedded in our current rate case filing. During
25 Docket No. R97-1, inflation had moderated relative to what was embedded in
26 that filing. And, the fact that overall inflationary pressures specific to the Postal
27 Service are quite different comparing Docket Nos. R97-1 and R2000-1 is
28 suggested by the relative magnitudes of the rate increases – 2.9 percent in
29 Docket No. R97-1, versus a proposed 6.5 percent in the current rate case. This
30 difference in rate increase percentages is not due to changes in the contingency

1 alone. Further, there is greater uncertainty pertaining to test year labor
2 expenses in this case than pertained in Docket No. R97-1, due to the fact that
3 the labor contracts for all major craft unions except city carriers will expire during
4 the test year of this rate case. These are all differences that factor into an
5 increased contingency.

6
7 III. DMA WITNESS BUC'S ONE-PERCENT CONTINGENCY PROPOSAL
8 SHOULD BE REJECTED
9

10 DMA Witness Buc makes several arguments disputing the
11 reasonableness of the Postal Service's 2.5 percent contingency provision. He
12 concludes that no more than a 1.0 percent contingency is justified. I disagree
13 with his arguments, as I explain below.

14 A. The Postal Service Has Followed an Appropriate Framework for
15 Determining the Contingency Provision
16

17 Witness Buc stated his opinion that the Postal Service has not followed
18 the appropriate "framework" for determining the contingency established by the
19 Commission in its prior Opinions. Tr. 22/9563. He and other intervenor
20 witnesses suggest that the Commission has determined that quantitative
21 measures centering on analysis of variances in estimates of costs and revenues,
22 versus actual operating results, should guide the selection of a contingency
23 provision. Tr. 22/9534, 9542 (Buc); 9714 (Burns).

24 I have been advised that, although in early decisions the Commission
25 expressed a hope that a quantitative approach, such as the historical variance
26 analysis, would prove workable, this view evolved over time. I have been
27 advised that, in more recent cases, the Commission expressed the views that
28 evaluation of the contingency should combine subjective judgment and objective
29 judgment, and it disclaimed necessary reliance on quantitative methods.² I

² See the Commission's Opinions and Recommended Decisions in Docket Nos. R87-1 and R94-1.

1 agree that this is an appropriate way to approach the Postal Service's policy
2 choice of a contingency provision.

3 In its most recent Opinion in an omnibus rate case (Docket No. R97-1),
4 the Commission made no reference at all to the usefulness of variance analysis.
5 It did not rely on any approaches more quantitative or objective than those used
6 by the Postal Service for determining the amount of the contingency. It is worth
7 recalling that, in Docket No. R97-1, the weighted average variances calculated
8 from the four previous test years would have implied the need for 3.5 percent
9 contingency, when applied to estimated test year costs, rather than the 1.0
10 percent contingency provision that the Postal Service used in determining its
11 revenue requirement, and that the Commission recommended.³ I find it
12 interesting that no party proposed relying on variance analysis to determine the
13 contingency provision in Docket No. R97-1.

14 The Postal Service has consistently provided a reasoned articulation of
15 risk in its rate case requests, and this case is no exception. While we have
16 consistently said that "variance analysis cannot be relied upon in a vacuum as
17 the basis for determining an appropriate contingency level" (see USPS-T-9,
18 p.45), Postal Service management does examine historical trends and performs
19 objective and quantitative analyses. These aid judgment in selecting the
20 contingency. This was explained by the Postal Service in its response to OCA
21 Question on the Contingency No. 2 (May 17, 2000), where we stated:

22
23 [T]he framework for assessing the reasonableness of the
24 contingency amount is embodied in a basic approach to identifying
25 sources of risk in estimating future needs. Some of these
26 uncertainties are more identifiable than others. To the extent they
27 can be identified, an attempt is usually made to evaluate the
28 potential effects on future needs by some order of magnitude (e.g.,
29 calculate the value of various percentage changes in revenue,
30 health benefits or wages). These potential effects are combined
31 with a more subjective assessment of the potential for totally

³ See Docket No. R97-1, Direct Testimony of William P. Tayman, Exhibit 9J, page 4).

1 unknown adversities in the current environment. This evaluation
2 necessarily also involves consideration of historical circumstances,
3 as well as knowledge of and forecasts for the economy in general,
4 operational challenges, market trends, and certain institutional
5 factors, such as the relative unpredictability of the collective
6 bargaining process. The overall sense of risk that emerges from
7 this evaluation is balanced subjectively against the other elements
8 of the Postal Service's proposals and policy choices, such as the
9 impact of rate increases on customers and the Board's policy
10 regarding equity restoration.
11

12 B. Lower Prior Years' Losses Do Not Support a Lower Contingency
13

14 Witness Buc supports his proposal for a lower contingency based also on
15 recent improvements in equity. He points out in his testimony (Table 3) that
16 equity improved to a negative \$446 million by the end of FY 1999. Tr.22/9545.
17 He also suggests that the current equity position could be improved, if the Postal
18 Service were to manage its real estate holdings more "rationally." Tr. 22/9566.

19 First, there is no logical connection between the status of equity
20 restoration, which is based mathematically on known, past financial results, and
21 the Postal Service's vulnerability to unknown future adversities or shortfalls. It
22 does not follow that improving the equity position should lead to increasingly
23 lower contingency provisions. If that were the case, Congress would not have
24 deemed it necessary to mandate that a reasonable contingency provision be
25 included in estimating revenue needs, in light of the fact that, when Congress
26 created the Postal Service in 1971, it had positive equity of \$1.7 billion.

27 The Postal Service remains strongly committed to eliminating its negative
28 equity position, as the Board of Governors affirmed in Resolution No. 95-9. It
29 would make no sense to risk that goal as justification for a potentially inadequate
30 contingency provision. Over time, inadequate contingencies will only contribute
31 to operating losses and to higher negative equity. Future rate-payers would have
32 to shoulder the consequences of our failure to provide adequately for
33 contingencies now.

1 Witness Buc contends that the appraised value of postal real estate is
2 higher than its book value, suggesting that negative equity is overstated. Tr.
3 22/9566. He states that the Postal Service's financial position could be improved
4 by carrying real estate at its book value. Tr. 22/9600. In other words, he
5 advises us, in effect, not to worry about future deficits resulting from unforeseen
6 events, because the Postal Service is in better financial shape than the books of
7 account would suggest. He also suggests that disposing of real estate, as an
8 additional source of revenue, could hypothetically contribute to equity
9 restoration. Tr. 22/9566,9600.

10 I do not believe that the Commission's recommendation should impose
11 that financial policy choice on the Postal Service. In any event, the credibility of
12 Witness Buc's contention that the Postal Service's financial condition is or could
13 be better, if real estate were managed differently, is suspect. He appears to
14 have limited expertise in real estate management, accounting theory, or the
15 Postal Service operations network. Tr. 22/9599-9602. His general argument is
16 speculative and does not bear specifically on the Postal Service's estimated
17 revenue needs in the test year. Furthermore, it ignores the legal and practical
18 realities of postal operations. The Postal Service has universal service
19 obligations and owns real estate for the purpose of supporting and operating a
20 nationwide service network to satisfy those obligations. The Postal Service
21 cannot dispose of its real estate at will in order to realize its market value.

22
23 C. The State of the Economy, As Well as a Return to Normal Growth in
24 Postal Volume, Support the Reasonableness of the 2.5 Percent
25 Contingency
26

27 Witness Buc testified that the state of the economy supports a lower
28 contingency. He provided no support for this conclusion beyond the three
29 inflation indices in Table 4 in his testimony. See Tr. 22/9570. He attempted to
30 bolster his argument by citing the unemployment rate as further evidence of a

1 strong economy. However, he does not explain how unemployment relates to
2 the Postal Service's estimated test year revenues and expenses.

3 The fact is that low unemployment indicates a tight labor market, as
4 witness Buc confirmed when asked. Tr. 22/9592. Low unemployment has
5 contributed to the increased wage expectations reflected in the ECI, which has
6 put additional pressure on Postal Service labor costs.

7 Inflation trends can be an important consideration in determining the size
8 of an appropriate contingency. In the case of the Postal Service, the most
9 relevant index is the ECI, since it serves as the benchmark for estimating test
10 year wage changes for most of the Postal Service's bargaining employees.
11 Wages are the Postal Service's most significant expense. Increases in the ECI
12 forecast portend potentially higher postal service wage rates. Witness Buc
13 confirmed the importance of the ECI as an indicator of test year wage changes,
14 as well as the fact that the ECI forecast is higher in this case than it was in either
15 of the last two rate cases. Tr. 22/9568-69.

16 The updated DRI indices provided in Exhibit USPS-ST-44AB indicate that
17 inflation has increased beyond what was predicted when the Postal Service
18 developed its Request. This volatility supports the need for a larger contingency,
19 not a lower one. The opposite was experienced during the last rate case, when
20 a 1.0 percent contingency was adopted. During Docket No. R97-1, inflation
21 dropped below what had been assumed at the time the Request was filed. Such
22 a difference in circumstances between the two rate cases validates the concerns
23 which led to the 2.5 contingency provision.

24 Even if the economy were to be stable throughout the test year, a strong
25 economy does not necessarily translate into a lower contingency provision.
26 Volume and revenue growth rates continue to be low and fall short of plan,
27 despite the current strong economy. In discussing the justification for a 2.5
28 percent contingency provision, Witness Tayman described the "increasingly
29 competitive environment in which the Postal Service operates." He stated:

1 In particular, the Internet appears to be making inroads into the
2 Postal Service's transaction and correspondence mail volume and
3 may be diverting advertising and marketing revenues from the
4 Postal Service as well. Our more traditional competitors appear to
5 be more aggressively pursuing legislative limitations on the Postal
6 Service's ability to operate in a business-like manner. In addition,
7 foreign postal administrations have been expanding their
8 operations into the United States."

9
10 USPS-T-9, at 44.

11
12 I agree with witness Tayman's characterization. I am concerned about
13 the adverse financial impact of weak volume growth, even if the economic
14 climate remains strong.

15 In my opinion, Postal Service witness Zarnowitz (USPS-RT-2) provides a
16 better informed and more balanced view than the intervenors of the risks
17 inherent in the economy. The uncertainty for the future embodied in the current
18 situation reinforces the need for a reasonable contingency of 2.5 percent.

19
20 IV. OCA WITNESS BURNS USES A MISGUIDED ANALOGY TO OPPOSE THE
21 PROPOSED CONTINGENCY PROVISION

22
23 OCA Witness Burns (OCA-T-2) criticizes the Postal Service's 2.5 percent
24 contingency provision, arguing that the Postal Service failed to articulate "a
25 reasonable basis for its subjective judgment." Tr. 22/9715. He maintains that a
26 contingency provision

27 cannot be adjudged to be reasonable without some justification
28 stemming from an assessment and systematic analysis of the risks
29 that the contingency reserve is expected to protect the Postal
30 Service against. Relying solely on management discretion to pick
31 the contingency reserve will not guarantee its reasonableness.

32
33 Tr. 22/9709. He concludes that witness Tayman's justification of the 2.5
34 percent provision "must be judged as primarily being a subjective
35 articulation of management's perception of unforeseeable and
36 uncontrollable risk." Tr. 22/9715.

1 I do not agree with witness Burns's suggestion that the Postal Service
2 relied "solely on discretion" to determine its contingency provision. To the extent
3 possible, an "assessment and systematic analysis of the risks that the
4 contingency reserve is expected to protect the Postal Service against" was in
5 fact done. This process was described in the Postal Service's response to OCA
6 Question 2 on the contingency, which I quoted above.

7 Witness Burns criticizes the Postal Service's approach by contrasting it
8 with the method employed by the insurance industry to determine insurance
9 reserves. Tr. 22/9709. In my opinion, this analogy is faulty. The insurance
10 industry and the Postal Service are very different. Witness Burns declares, but
11 makes no effort to explain and justify why the nature and function of the
12 insurance reserve is similar to the contingency in the Postal Service's revenue
13 requirement. At a level of from 13 to 18 percent, in effect (see Tr. 22/ 9726-27),
14 typical insurance industry reserves exceed by more than five times the proposed
15 2.5 percent contingency provision. As witness Burns confirms, furthermore,
16 insurance companies differ fundamentally from the Postal Service, because they
17 are allowed to earn profits and most have positive equity. In other words, the
18 role and size of insurance reserves as a financial cushion, and the abilities of the
19 insurance companies to absorb future adversities differ fundamentally from the
20 functions the contingency performs in the Postal Service's revenue requirement.
21 Tr. 22/9723. In fact, it was no doubt largely because the Postal Service, with its
22 break-even mandate, does not have the profit margins or provisions for return on
23 investment enjoyed by other firms that Congress believed it important to provide
24 for contingencies in outlining the revenue requirement in 39 U.S.C. § 3621.

25 Adhering to his inapt analogy, Witness Burns emphasizes that "the Postal
26 Service has failed to perform the type of probability analysis and quantitative
27 assessment that the insurance industry performs." Tr. 22/9728. Again, his
28 analogy is inappropriate and incomplete, and it fails to account for essential
29 differences. In particular, the purpose of insurance reserves is significantly
30 different from the function of the contingency. In order to guarantee that there

1 will be enough money to pay on their customers claims, insurance companies
2 seek to predict whether the random occurrence of accidents or natural disasters
3 will differ from a historical pattern. Witness Burns testifies that probability
4 analysis is used in the insurance industry "to predict the likely number, severity,
5 and location" of catastrophes." Tr. 22/9744. He further testifies that "items for
6 which a history exists," such as natural catastrophes," lend themselves to
7 probability and variance analysis more readily than items for which no history
8 exists." Tr. 22/9746. By contrast, the contingency in postal ratemaking is
9 designed to protect against the totally unknown and "known unknowns," such as
10 volume erosion due to the Internet or future legislation. There is no history for
11 the totally unknown and there is usually insufficient history for "known unknowns"
12 on which to base a probability analysis. A totally unknown adverse event that
13 depended on complicated political relationships, such as the unplanned
14 legislative transfer of Post Office Department annuitant costs to the Postal
15 Service (which occurred under the Omnibus Budget and Reconciliation Act
16 (OBRA) of 1990) simply could not have been predicted by a probability analysis.

17 The contingency provision is designed to maintain stability in achieving
18 the break-even mandate, in light of the largely unpredictable consequences of an
19 interplay among a complicated array of economic, social, and political forces, as
20 well as accidents and natural disasters. Most fundamentally, Witness Burns
21 does not explain whether and how the estimation of insurance industry reserves,
22 beyond merely assessing probabilities of predictable occurrences, treats critical
23 drivers of uncertainty relating to the Postal Service contingency provision, such
24 as the future state of the economy, inflation, labor contract negotiations,
25 legislative change, arbitration awards, and volume growth. In my opinion,
26 predicting the consequences of unknown change among these complex and
27 interrelated factors and conditions is much more complicated than predicting the
28 probability of changes in accident rates, for example. Furthermore, apart from
29 merely predicting the level of future expenses, the contingency has an important

1 policy dimension, in that it represents the level of risk that postal management is
2 prepared to accept in directing the Postal Service's operations and finances.

3 When asked if he had used any of the forecasting methods he advocates
4 to calculate the OCA's proposed 1.0 percent contingency, Witness Burns
5 confirmed that he had not. Tr. 22/9748. In my opinion, no such analyses were
6 performed, because the type of probability analysis used by the insurance
7 industry would be inappropriate and ineffective in the financial management of
8 the Postal Service.

9
10 V. OCA WITNESS ROSENBERG'S ANALYSIS DOES NOT SUPPORT
11 OVERRIDING THE 2.5 PERCENT CONTINGENCY PROVISION
12

13 OCA witness Rosenberg says a contingency provision of 2.5 percent of
14 total estimated costs is neither necessary nor in the public interest at this time.
15 Tr. 22/9807. He testifies that historical and forecasted inflation and economic
16 growth data, along with the history of success under previously-recommended
17 contingency provisions, support a 1.0 percent contingency. See Tr. 22/9812-18.
18 OCA Witness Burns supports Witness Rosenberg's analysis. Tr. 22/9725.

19 As I have already discussed with regard to witness Buc, the Commission
20 has not established firm, objective guidelines that would conform to witnesses
21 Rosenberg's and Burns's formalistic prescriptions for justifying the contingency.
22 Further, witness Rosenberg's selection of a 1.0 percent contingency is itself, to a
23 large extent, subjective and judgmental. As explained below, an alternative
24 analysis that groups the data relied upon by witness Rosenberg more rationally
25 supports the Postal Service's 2.5 percent contingency, rather than witness
26 Rosenberg's 1.0 percent recommendation.

27 Witness Rosenberg contends that the current economy is "operating in a
28 climate of relatively low inflation." Tr. 22/9812. His Table 5 compares historical
29 consumer price inflation to historical rate case contingency amounts
30 recommended by the PRC. He concludes that

1 the time path of inflation has both trended lower and become less
2 erratic in recent years. Both lower inflation and less erratic inflation
3 are factors that support a smaller contingency provision.
4

5 Tr. 22/9819.

6 Witness Rosenberg's analysis is flawed. First, he relies totally on
7 historical inflation data to correlate inflation and the contingency. But, the data
8 most relevant to the test year are forecasted, not historical data. In the analysis
9 below, I include forecasted FY 2000 and FY 2001 data that are omitted from
10 Witness Rosenberg's Table 5. This results in a more meaningful analysis.
11 Second, witness Rosenberg's analysis focuses on CPI instead of ECI. The CPI
12 measures inflation in consumer goods and services, but these differ from the
13 goods and services predominantly used by the Postal Service. The largest
14 Postal Service expense consists of wages, which are not measured by the CPI.
15 COLAs paid to postal employees are based on changes in the CPI, but CPI is
16 only one of several wage increase components that are benchmarked in total
17 against the ECI. New COLAs effective in the test year are projected only for city
18 carriers, and amount to a small portion of the estimated increase in postal
19 wages. Third, Witness Rosenberg's grouping of inflation and contingency data
20 into five-year intervals is arbitrary and masks the true relationships between
21 inflation and contingency amounts.

22 My Table 1, "History of Key Inflation Indices and Contingencies" shows a
23 different picture.

Table 1
History Of Key Inflation Indices
And Contingencies

Rate Case	Fiscal Year	Contingency	CPI-W	ECI
R87-1	1986		2.16	3.85
	1987		2.68	3.01
	1988		4.06	3.47
Test Year	1989		4.76	4.13
	Average	3.5	3.42	3.62
R90-1	1990		4.83	4.28
	1991		4.91	3.88
Test Year	1992		2.84	3.26
	Average	3.5	4.19	3.81
R94-1	1993		2.93	2.73
	1994		2.49	2.99
Test Year	1995		2.86	2.87
	Average	2.0	2.76	2.86
R97-1	1996		2.77	3.16
	1997		2.59	3.36
Test Year	1998		1.41	3.99
	Average	1.0	2.26	3.50
R2000-1	1999		1.90	3.56
	2000		3.29	4.03
Test Year	2001		2.50	4.53
	Average	2.5	2.56	4.04

Source: USPS-RT-1A

Instead of following Witness Rosenberg's arbitrary convention of grouping data by five-year increments, this Table, and the related Exhibit (USPS-RT-1A, attached), group the data by rate case test year, and by the years feeding into each test year. Also, all Docket No. R2000-1 data are included, not merely data through the end of 1999. By including all the R2000-1 data, this analysis shows that inflation rates are actually increasing, rather than decreasing. For example, the average CPI-W estimate for Docket No. R2000-1 spikes up relative to the Docket No. R97-1 rate case. Further, the FY 2000 CPI-W inflation rate spikes to the highest level in almost a decade. As for the more important ECI index, the Docket No. R2000-1 average inflation rate is the greatest of each of the five rate

1 cases listed, and the test year inflation rate is the greatest over the entire 15
2 years included in Table 1.

3 As shown in Exhibit USPS-RT-1A, every one of the eleven key indices
4 shows a larger increase in the Docket No. R2000-1 test year than the increases
5 that occurred in the Docket No. R97-1 test year. Seven of the eleven indices
6 show a larger test year increase than the increases that occurred in the Docket
7 No. R94-1 test year, when the proposed contingency was 2.0 percent. Following
8 Witness Rosenberg's reasoning, it appears that these inflationary trends actually
9 support, rather than refute, the 2.5 percent contingency. In fact, these data
10 taken alone could support an even higher contingency, because the rate of
11 increase in ECI is now higher than it was the last two times a 3.5 percent
12 contingency was selected.

13 Another specific indication of inflation's adverse impact on the Postal
14 Service relates the recent surge in fuel prices reflected in Exhibit USPS-RT-1A.
15 Principal competitors of the Postal Service, FedEx and UPS, imposed fuel
16 surcharges to recover the costs associated with this cost increase shortly after
17 the rise in fuel prices. The Postal Service has no such mechanism in its rate
18 setting processes to rapidly impose a surcharge. Postal rate changes are
19 subject to a 10 month statutory process that requires considerable additional
20 time for planning and preparation. The contingency helps the Postal Service
21 protect itself against adversities that cannot be countered due to this lengthy
22 regulatory lag period.

23 Witness Rosenberg also asserts that the Postal Service's recent string of
24 positive net incomes supports a low contingency. Tr. 22/9815. The need for a
25 reasonable provision for contingencies, however, is not limited to periods
26 experiencing financial losses. As discussed above, I am concerned about the
27 declining trend in our net incomes that has developed, in spite of recent financial
28 successes and favorable economic conditions. Net income has declined in
29 every year since FY 1995, and the Postal Service is \$436 million behind its FY
30 2000 net income plan through accounting period 11.

1 Consistent with this most recent performance, in the Postal Service's
2 response to Order No. 1294, we estimated a FY 2000 net loss of \$325 million.
3 Our estimate for the test year was also updated, and it now shows an after-rates
4 deficiency of \$475 million. See Exhibit USPS-ST-44A and Revised Response to
5 POIR 14. In this regard, it is important to note that the updated test year
6 deficiency would have been much larger without the benefit of offsetting cost
7 decreases due to breakthrough productivity initiatives, and increases in
8 miscellaneous revenue due to revenue generation initiatives. In other words, in
9 light of this updated information, increased costs are very likely to be incurred. In
10 addition, the offsetting cost reductions and the generation of additional
11 miscellaneous revenue, which are critical to achieving test year financial goals,
12 clearly involve a heightened degree of risk. Given this higher level of
13 uncertainty, it would not be reasonable for the contingency provision to be any
14 lower than 2.5 percent.

15 Witness Rosenberg concludes that the contingency should be reduced
16 because

17 other things being equal, relatively favorable and stable economic
18 conditions at present and forecasts of reasonable stability over the
19 near-term future can be expected to strengthen the ability of the
20 Postal Service to forecast revenues and expenses on a going
21 forward basis, so the Postal Service's estimates would be expected
22 to be more reliable now than in more uncertain times.

23
24 Tr. 22/9811.
25

26 But, as witness Rosenberg also testified, "other things are rarely equal." Tr.
27 22/9852. I noted above, with regard to witness Buc, that a favorable economy
28 has not translated into strong volume and revenue growth for the Postal Service.
29 In fact, one element of current economic strength — strong employment — has
30 actually had an adverse impact on the Postal Service, because it has put
31 pressure on postal wages. The current strong economy has also resulted in a
32 recent round of interest rate increases by the Federal Reserve. The Fed is

1 concerned that the economy is overheating, and this could lead to an even larger
2 jump in inflation than we have already seen. Higher interest rates have
3 increased the Postal Service's cost of borrowing, and further interest rate hikes
4 remain possible. These developments have increased the possibility of an
5 economic slowdown, which could cause additional harm to the Postal Service's
6 already weak volume and revenue growth.

7 Witness Rosenberg also advises that the Postal Service should not use
8 the contingency provision to restore equity. See Tr.22/9830-32. I think his
9 concern is misplaced as a policy matter, since our equity is currently negative,
10 and we remain almost \$3 billion short of restoring prior years' losses. USPS-ST-
11 44, p. 8. More directly to his point, however, it does appear quite possible that a
12 very appreciable portion of the contingency will not be available to the Postal
13 Service in FY 2001. It is, for example, well known that the Postal Service does
14 not plan to implement rates until January of 2001. This means that more than a
15 quarter of the test year, including the high volume and revenue Fall and Holiday
16 mailing seasons, will have passed before the Postal Service receives the benefit
17 of new rates. Based on this timing alone, much of the test-year contingency
18 provision will be consumed in FY 2001. Much of the remainder of the
19 contingency is likely to be eliminated by the \$651.5 cost increase now estimated
20 for the test year.⁴ If other financial risks materialize, such as failure to achieve
21 all of the bold breakthrough productivity cost savings projections, continued
22 slowing of volume growth, and a shortfall in our new revenue generation
23 initiatives, or adverse legislation,⁵ it is possible that none of the 2.5 percent
24 contingency provision would actually be unconsumed.

⁴ In witness Tayman's testimony (USPS-9A), total accrued costs are \$67,190.6 million. Witness Patelunas's estimate in USPS-ST-44A is \$67,642.1 million. In his revised response to POIR 14, witness Patelunas identified \$200 million additional expense item that was inadvertently omitted from his rollforward.

⁵ Both the Senate (S.1232) and the House (H.R. 416) have passed legislation to fix retirement errors for those employees erroneously placed in the wrong retirement system. It is estimated that approximately 20,000 federal employees

1 Finally, Witness Rosenberg presents a list of what he refers to as "safety
2 nets" that he claims reduce the need for a contingency. See Tr. 22/ 9828-33.
3 These include borrowing authority, a mechanism to recover prior years' losses,
4 the use of pro forma revenue and expense estimates in rate cases,
5 management's ability to control expenses, and the ability to request new rates.
6 All of these factors are considered when the Postal Service determines its
7 contingency. None of them is intended to protect against incurring a loss in the
8 test year as a result of unknown adverse events or estimating errors. I therefore
9 disagree strongly that the existence of any of these factors supports a lower
10 contingency.

11 Consider for example, management's ability to control expenses.
12 Through AP 11 of Fiscal Year 2000, workhours are 0.7 percent less than the
13 same period in the prior year, while the number of new delivery points
14 (approximately 1.7 million) would require approximately 6000 new carriers (letter
15 and rural) and the equivalent space in delivery facilities, which would cost
16 upwards of \$500 million. This is strong performance, yet we remain below our
17 net income plan. There are limits to how much control can be exerted. The FY
18 2001 preliminary plan is even more challenging, as it calls for a 1.7 percent
19 decrease in workhours, also with further volume and delivery point growth.
20 Nevertheless, management is obligated to maintain and improve the quality of
21 service.

22
23 VI. WITNESS HALDI'S \$94 MILLION PRODUCTIVITY ADJUSTMENT
24 SHOULD BE REJECTED
25

26 Witness Haldi, on behalf of ANM, proposes a \$94 million productivity
27 related adjustment to periodicals costs. Tr. 22/9653. He urges this amount be

were placed in the wrong retirement plan. The Congressional Budget Office estimates the cost to be in the range of \$121 million for the entire federal government. There will be a cost to the Postal Service to correct these errors, but when and how much has not yet been determined, nor estimated.

1 disallowed from the revenue requirement. Tr. 22/9654. In order to calculate this
2 adjustment, witness Haldi relies on a series of wage-adjusted unit flat costs from
3 1989 through 1998. He takes 1993 as his base period. Tr. 22/9655. This is
4 the year with the lowest unit cost. He does not review the projected unit costs
5 through the test year. He takes the difference between the 1993 and 1998 unit
6 costs and multiplies those by the 1998 volumes to derive the \$94 million
7 adjustment. Tr. 22/9656. He claims that inadequate capital investment in flats
8 processing equipment has driven up the unit costs for flats and cites Total Factor
9 Productivity trends. See Tr. 22/9619.

10 Witness Haldi's adjustment should be rejected. His support for the
11 productivity adjustment is based on faulty premises concerning the appropriate
12 level of capital investment in the Postal Service and the skewed selection of a
13 base period. Total Factor Productivity relates to Postal Service productivity as a
14 whole and does not isolate productivity performance for any particular shape or
15 type of mail. Also, by stopping his analysis in FY 1998, witness Haldi fails to
16 calculate or acknowledge the degree to which the new and expanded cost
17 savings programs built into the Postal Service test year estimates will moderate
18 the growth in periodical costs.

19 Witness Haldi says that the Postal Service's rate of net investment is far
20 lower than that achieved by efficient firms in competitive industries. He cites the
21 fact that Quad/Graphics has spent 20 percent of its revenue on investment in
22 automation over the past 25 years. Tr. 22/9628. However, he also
23 acknowledges that Quad/Graphics is in the printing business. Tr. 22/9677. I do
24 not believe it reasonable to expect a service firm, such as the Postal Service, to
25 invest a similar proportion of its revenues in automation as would a printer, like
26 Quad/Graphics. Quad/Graphics is a highly valued customer, but it is in a
27 distinctly different line of business.

28 Witness Haldi criticizes the Postal Service's depreciation expense
29 average of 2.4 percent of revenues for being "far below the national average for
30 nonfinancial corporate businesses of about 11 percent." Tr. 22/9625. The

1 Postal Service, however, is not an "average" nonfinancial business. If such
2 comparisons are to be made at all, United Parcel Service (UPS) likely would
3 provide a sounder basis for comparison than would a national average. Witness
4 Haldi testified that UPS's reported depreciation expense averaged 4.5 percent of
5 the revenues for the period 1997 through 1999, compared to 2.8 percent for the
6 Postal Service over the same time period. Tr. 22/9675. He also testified that
7 about 25 percent of UPS's assets are aircraft. *Id.* As the Postal Service's
8 business practice is to contract for air transportation or to use commercial air
9 transportation rather than to purchase aircraft, and the Postal Service does not
10 capitalize leases for any aircraft, none of the Postal Service's depreciation
11 expense relates to aircraft. Making allowance for this different Postal Service
12 business practice would reduce UPS's estimated depreciation expense by 25
13 percent to 3.4 percent of total revenues, which is very close to the Postal
14 Service's 2.8 percent. If further allowances were made for depreciation expense
15 forgone by the Postal Service's policy to contract for inter-city surface
16 transportation, the Postal Service and UPS depreciation percentages would
17 further converge.

18 Witness Haldi's calculation of his proposed \$94 million disallowance is
19 predicated on a 1993 base year. See Tr. 22/9655-56. This inappropriate base
20 period distorts the trend of periodical cost growth. Unit labor costs were
21 unusually low in 1993. As witness Haldi acknowledged on cross-examination,
22 there were reductions in craft employees in 1993 and these reductions "didn't
23 last very long.". Tr. 22/9700. These reductions resulted from the Postal
24 Service's restructuring that took effect in early Fiscal Year 1993. Service
25 suffered dramatically in 1993, because too many craft employees accepted
26 separation incentives. The majority of the 47,000 employees who retired were
27 craft employees (34,000 bargaining unit employees). Most of these needed to
28 be subsequently replaced in order to process and deliver the mail. Service
29 suffered. This level of service which prevailed in Dr. Haldi's base period proved

1 to be unacceptable to our customers, particularly including Periodicals mailers.
2 It is not a representative base period for calculating productivity.

3 Dr. Haldi's proposal is further skewed by his failure to account for cost
4 savings programs that inure to the benefit of Periodicals between the base year
5 and the test year of this rate case. The only specific cost reduction program he
6 would allow to offset the proposed revenue requirement disallowance is for the
7 AFSM 100s. See Tr. 22/9689. His refusal to incorporate the impact of
8 numerous other cost savings programs reveals an unbalanced approach that
9 should be rejected.

10 I do not believe it prudent to disallow expenses, simply because there has
11 been an increase in unit costs for a particular service. In particular cases, unit
12 cost increases may reflect investments in improving the quality of service or
13 changes in the makeup of the mailstream that are not easily quantifiable. There
14 are many, sometimes highly complex reasons for changes in unit costs.

15 Finally, witness Dowling's rebuttal testimony demonstrates that the Postal
16 Service has pursued flats automation opportunities in a responsible way.
17 Although the Postal Service is striving to improve the efficiency of flats
18 processing, the underlying circumstances do not demonstrate that the Postal
19 Service is inefficient. Flats automation presents a much greater challenge than
20 letter automation. That is inherent in the much wider variation in the physical
21 characteristics of flat mail. I believe that we are beginning to make progress in
22 this area, and am hopeful that we will be able turn the corner on flats automation
23 over the next decade, much like we were able to turn the corner on letter
24 automation in the 1990's.

25
26 VII. WITNESS PATELUNAS'S SUPPLEMENTAL TESTIMONY REFLECTS
27 THE NEED FOR THE POSTAL SERVICE'S REVENUE REQUIREMENT.
28

29 In response to Commission Order No. 1294 and subsequent inquiries, the
30 Postal Service filed numerous materials reflecting the FY 1999 Cost and
31 Revenue Analysis (CRA) Report, and other data and projections that are more

1 recent than information that was available when the Postal Service's Request
2 and testimony in this docket were filed. These additional materials included the
3 Supplemental Testimony of Mr. Patelunas, as well as numerous exhibits, library
4 references, and responses to written questions. Most of this updated and
5 revised information has a significant bearing on the Postal Service's proposals,
6 and particularly on issues that have been raised pertaining to the Postal
7 Service's requirement.

8 In the following, I provide an overview of the salient elements of the
9 updated financial projections prepared by the Postal Service pursuant to the
10 Commission's directive. I am not fully conversant with all of the implications of
11 the complex array of interrelated issues raised by the updates. I will, however,
12 attempt to place this information in the appropriate context, at least with respect
13 to the Postal Service's revenue goals and the issues raised in this rebuttal
14 testimony.

15 Whenever the Postal Service prepares a case to support general rate
16 increases, it must make numerous compromises sacrificing its ability to update
17 for more recent information that becomes available just prior to filing and during
18 the lengthy ten-month litigation cycle. This situation results, not only from the
19 nature of the rate setting process, but, from the Postal Service's perspective, in
20 part from limitations on the personnel and resources required to put a case
21 together. These inflexibilities, moreover, are also caused by the interplay of a
22 variety of other factors, such as the timing of complex financial reports and
23 special studies, and the need to conform to Commission rules requiring
24 extensive documentation and explanation of the Postal Service's proposals. As
25 a result of these complexities, preparation of a Postal Service Request takes
26 many months, and commonly, at the time of filing and during litigation, more
27 recent information comes out that, if incorporated, would have the effect of
28 casting some of the Postal Service's proposals in a different light. Typically, the
29 Postal Service tries to approach these situations responsibly by not presenting

1 the Commission and litigants with a moving target to consider in evaluating the
2 Postal Service's needs and proposals.

3 I am told that in recent years there has been an increasing tendency for
4 the Commission to try to incorporate the most current information available
5 before the rate case is concluded, particularly when major financial and
6 operational reports become available. The Commission's ability to
7 accommodate these updates has usually been, and should be, subject to the
8 need to give all of the parties a fair opportunity to explore and comment on the
9 new information. This tendency seems to be particularly strong in circumstances
10 like those prevailing in the last rate case (Docket No. R97-1), in which the Postal
11 Service was faring financially better than had been expected when the case was
12 filed. I am told that, over the years, the inclination to take account of new
13 information has been much weaker or nonexistent when current information
14 merely reinforced the original request or made clear that even more revenue
15 might be needed to cover increasing costs.

16 It is my understanding that the Postal Service originally prepared the
17 current case to file in the fall of 1999. When it was actually filed in January of
18 2000, the assumptions and base data were still viable to constitute a realistic
19 foundation for the Postal Service's proposals, although some of the economic
20 estimates had been overtaken somewhat by more recent information and
21 projections. In fact, to the extent possible, the Postal Service had already
22 incorporated some FY 1999 financial data in the original filing. As we all know,
23 furthermore, approximately a little more than three months after filing, the Postal
24 Service's FY 1999 CRA Report became available and was submitted to the
25 Commission.

26 The Postal Service's response to this situation was and is to continue to
27 maintain the basic revenue goals incorporated in the original filing. This decision
28 is driven in large part by the aforementioned disinclination to present a moving
29 target and to needlessly complicate the litigation. Candidly, however, it is also
30 motivated by the realities involved in presenting a comprehensive and

1 completely accurate foundation for Postal Service proposals, fully explained and
2 documented in accordance with the Commission's rules and other requirements.
3 In other words, as the Postal Service has repeatedly emphasized, there has not
4 been enough time in this proceeding to replicate all the necessary elements of a
5 Postal Service rate request. We have made a good faith effort to comply with the
6 Commission's directives and parties' requests up to this point, but only time and
7 events will tell to what extent the Commission can rely on the updated
8 information. Particular problems have been presented adjusting for and
9 reconciling the dictates of the ratemaking process, which requires a relatively
10 static record, and the budget and planning processes, which are dynamic and
11 continually evolving. In this regard, we have presented an accurate and fair
12 assessment of future needs for ratemaking purposes, while trying not to
13 abandon the goal-setting and management dimensions of the planning process,
14 which is essential to improvement and efficiency. Inevitably the appearance of
15 inconsistencies might have been created in presenting the updated information.
16 Wherever possible, however, we have tried to reconcile the revisions in favor of
17 improvements in our revenue and expense outlook that are fair to both the
18 mailers and other intervenors, as well as the Postal Service.

19 Witness Patelunas's Supplemental Testimony, USPS-ST-44, includes the
20 impact of updated test year costs, as requested by Order No. 1294. It also
21 includes several new revenue initiatives. The inputs and revisions used in
22 running his new rollforward were intended to reflect material changes that had
23 occurred since the filing, as well as significant changes in management plans
24 and objectives, and changes required to permit the most realistic and accurate
25 estimates for the test year. I believe that these revisions are essential
26 considerations if the Commission attempts to incorporate the updates in its
27 recommendations.

28 The updates in USPS-ST-44 reflect the major cost and revenue drivers of
29 test year estimates that could be incorporated, given the time and resources
30 available. They include the following.

- 1 1. Updated Base Year Data. In conformance with Order No. 1294, base year
2 accounting, Cost and Revenue Analysis and related labor data were updated
3 to reflect final FY 1999 results.
- 4 2. Updated Cost Level Data. Key inflation level indices were updated.
5 Because actual and forecasted inflation had grown since the Postal Service
6 filed the case, these updates increased test year costs. Also, the test year
7 ECI minus 1 assumption was changed to an assumption that reflects
8 management's expectation of what will be a more realistic outcome. As
9 noted at USPS-ST-44, p. 3, after subtracting "carryover costs, the effective
10 change in wages related to the new contract is ... 1.7 to 1.8 percent less than
11 the Employment Cost Index."
- 12 3. Test Year Cost Reductions. Test year cost reductions were updated to
13 reflect the impact of breakthrough productivity initiatives and Periodicals
14 initiatives. The breakthrough productivity initiatives represent management's
15 attempt to offset adverse inflationary impacts. These initiatives represent a
16 significant challenge and are at greater risk of achievement than the cost
17 savings programs included in the Postal Service's Request.⁶

⁶ In discussions pertaining to these adjustments, there has been some confusion regarding the character and impact of the approximately \$200 million "field reserve." There has been some suggestion that this expense is merely an element of the contingency provision. This conclusion is wrong. In estimating the cost savings associated with breakthrough productivity initiatives, witness Patelunas intended to net out the impact of a \$200 million field reserve. The field reserve is an actual budget expense item that the Postal Service projects it will spend during the test year. It is as real as any other expense in the Postal Service's budget. It has not yet been assigned to a particular expense account, pending evaluation in the field of the particular needs of each location as the year progresses. Its status is similar to a series of other reserved line items in the Postal Service's budget process. For example, budgeted field expenses for projected COLAs and increased health benefit expenses are held in a headquarters reserve account at the beginning of the year. They are not allocated to field operating units until well into the budget year, when the actual CPIs (in the case of COLAs) and the actual health benefit increases are known. The reserve is then distributed to the field as needed as the year progresses. In the same way, the breakthrough productivity field reserve will be distributed as

- 1 4. Other Programs. Various other program costs were increased or decreased
2 to reflect more current data or to accord with the Postal Service's most recent
3 plans, as explained at USPS-ST-44, pp. 5-7. Even though current data and
4 trends would support significantly higher workers' compensation expense⁷,
5 this update held test year workers' compensation expenses at the FY 2000
6 level. This is another area of significant financial uncertainty and risk.
- 7 5. Workyear Mix Adjustment. Current workyear trends were reflected.
- 8 6. Revenue Projections. The impact of three new revenue initiatives was added
9 to the test year – Retail Product Sales of \$100 million, co-branded advertising
10 revenue of \$100 million, and E-Business revenue of \$104 million. Because
11 these initiatives call for significantly stretching our sales and marketing
12 accomplishments beyond our historical base, the \$304 million of projected
13 revenue is at greater risk than the basic revenue projections reflected in the
14 econometric forecast filed with the case.

15
16 I am aware that, during witness Patelunas' cross examination and in other
17 communications subsequent to witness Patelunas' appearance, issues have
18 been raised concerning the Postal Service's updated labor cost increase
19 assumptions. I want to respond to those issues here.

20 It will be recalled that Postal Rate Commission Order (PRC) No. 1294
21 required the Postal Service to update the test year forecasts to incorporate FY
22 1999 CRA results and "to incorporate with this information such other updates as

needed as the year progresses, once it is known where and for what the funds are needed. Breakthrough productivity is most certainly not a new contingency provision beyond what was included in the Postal Service's request. To the contrary, it represents a new level of increased risk for the Postal Service, further supporting the need for the Postal Service's 2.5 percent contingency provision.

⁷ To date, we have been unable to ascertain the reason for this development. There has been a very significant increase in the number of cases approved by the Department of Labor, without a parallel increase in accident rates. We are seeking a conference to explore whether this results from a one-time acceleration in the speed of processing of cases, or a trend that will significantly

1 it believes will more accurately reflect test year results." Consistent with this
2 requirement, in calculating changes in wage rates for those bargaining units
3 whose contracts expire in the test year, the Postal Service utilized a calculation
4 assuming an ECI as opposed to ECI minus 1 wage increase. We made this
5 change in order to present the most realistic and accurate labor cost
6 assumptions for the test year. It is, in my opinion, extremely conservative, since
7 we have also included record-setting productivity.

8 The updated labor cost estimate presented in response to PRC Order No.
9 1294 does not abandon our historical collective bargaining position. The Postal
10 Service's negotiating position has been, and continues to be, that negotiated
11 wage increases should not exceed, on a contract year basis, ECI minus 1. The
12 net result of this update, after incorporating a higher ECI index and the carryover
13 of cost increases from existing contracts into the test year, is a "new money"
14 wage increase of ECI minus 1.7 to 1.8, fully consistent with the Postal Service's
15 historical bargaining goals.

16 As stated above, this rebuttal testimony and the rollforward previously filed by
17 witness Patelunas are not intended to supplant the Postal Service's Request.
18 The Postal Service's Request is an integrated and balanced proposal that
19 complies with legal requirements and considers all relevant factors. As
20 explained, furthermore, time and resources have not permitted a comprehensive
21 update of the Postal Service's filing. In this regard, Witness Patelunas included
22 in the updated rollforward all material changes that could practically be included
23 without totally rebuilding the rate case from the bottom up. Those rollforward
24 results indicate that our revenue needs have increased since we filed this case,
25 and they further support the need for the 2.5 percent contingency provision.
26 Because witness Patelunas strove to include all material changes, if the
27 Commission were to attempt to update test year projections, care should be
28 taken to include all the updates included in witness Patleunas's rollforward. To

increase accrued expenses in FY 2001.

1 not do so would unbalance the record and would jeopardize the Postal Service's
2 financial performance.

3 Even though the Postal Service is not changing its original revenue request, I
4 am particularly concerned about the overall level of revenues and the integrity of
5 the Postal Service's proposed contingency provision. Witness Patelunas's
6 supplemental testimony, as corrected by his revised response to POIR 14,
7 indicates a test year after rates deficiency of \$475 million. That projection occurs
8 as a result of making a number of very aggressive assumptions regarding cost
9 levels, cost savings, and revenue. When these are considered as a package,
10 along with the changed circumstances from the last rate case, the potential
11 volatility of the economy, the Postal Service's current financial performance, and
12 the evolving competitive environment, the Postal Service's revenue requirement
13 is clearly justified. In particular, proposal of a contingency provision representing
14 2.5 percent of overall expenses reflects an important policy choice that cannot
15 be circumvented by merely recommending the dollar amount of the contingency
16 in the Postal Service's original revenue request within the context of a revised
17 revenue requirement. In my opinion, failure to adopt the 2.5 percent contingency
18 on the terms proposed would constitute an unacceptable rejection of the
19 proposal.

20 21 VIII. SUMMARY AND CONCLUSIONS

22
23 The Postal Service's contingency provision falls within a well-established
24 range of reasonableness. Circumstances have changed since that last rate case
25 and support the need for the Postal Service's 2.5 percent contingency provision.
26 It should be accepted.

27 In particular, the baseless claim that the Postal Service's selection of a
28 contingency provision was arbitrary, and incapable of being assessed as
29 reasonable, should be laid to rest. I agree with witness Tayman's clear
30 justification for a 2.5 percent contingency amount. In addition, in the discussions

1 above, I have identified numerous factors that support the proposed contingency
2 provision, both objectively, and as exercise of the Board of Governors' policy
3 judgment as to the level of risk against unknown adversities that the Postal
4 Service should take in these circumstances. Of the pertinent factors, I have
5 discussed the rising trend in inflation, the uncertainty of the labor contract
6 situation, adverse financial trends, the effect of January implementation, the
7 aggressive nature of the Postal Service's assumptions regarding future
8 expenses and cost reduction initiatives, uncertain trends in revenue generation,
9 and the possibility of adverse legislation, among others.

10 DMA witness Buc's proposal to reduce the contingency provision should
11 be rejected. Contrary to witness Buc's testimony, the Postal Service follows an
12 appropriate framework for establishing the contingency. Further, the
13 contingency provision should not be reduced by virtue of revaluing real estate
14 assets or requiring the Postal Service to dispose of those assets at market value.
15 Prior years' loss recovery does not obviate the need for the Postal Service's
16 reasonable contingency, nor does the state of the economy.

17 Similarly, the OCA's proposed contingency provision should be rejected.
18 OCA witness Burns uses a seriously flawed insurance analogy to support the
19 OCA proposal. OCA witness Rosenberg's support for the OCA proposal relies
20 on flawed assumptions about economic trends and mistaken assumptions
21 concerning the state of the economy.

22 ANM witness Haldi's proposed productivity adjustment should be denied.
23 He has not shown that the Postal Service is operating inefficiently.

24 Finally, the Postal Service would prefer to stand on the revenue
25 requirement in its original request, rather than rely on a financial foundation that
26 is less than comprehensive and might not meet standards of fairness in this
27 litigation. Nevertheless, we must point out that new data and information that
28 has become available since the Request was filed reinforces the need for the
29 level of increase revenues requested.

**History of Key Inflation Indexes and Contingencies
R87-1 to R00-1**

USPS-RT-1A

	Contingency	Fiscal Yr	CPI -W	ECI 1/ Wages and Salaries	ECI 1/ Benefits	Air Freight	Interstate Trucking	Rents	Paper and Paper Product	Supplies & Materials	Gas & Oil	Natural Gas	Electricity
R87-1		1986	2.16	3.85	3.49	n/a	n/a	6.17	-1.34	-2.59	-13.79	-4.46	2.14
		1987	2.68	3.01	3.17	n/a	n/a	4.47	5.64	0.11	-9.24	-5.12	-1.04
		1988	4.06	3.47	5.33	n/a	n/a	3.81	8.55	5.41	5.84	-2.05	1.16
Test Year		1989	4.76	4.13	6	n/a	n/a	3.79	7.41	5.22	6.98	3.05	2.85
	3.5	Average	3.42	3.62	4.50			4.56	5.07	2.04	-2.55	-2.15	1.28
R90-1		1990	4.83	4.28	6.69	-0.72	n/a	4.21	1.51	1.72	7.41	0.4	2.54
		1991	4.91	3.88	6.27	3.11	n/a	3.85	-1.7	1.89	11.66	1.06	3.14
Test Year		1992	2.84	3.26	5.88	0.96	n/a	2.65	-1.39	-0.77	-5.7	0.97	2.52
	3.5	Average	4.19	3.81	6.28	1.12		3.57	-0.53	0.95	4.46	0.81	2.73
R94-1		1993	2.93	2.73	5.47	5.32	n/a	2.39	-0.68	1.36	0.56	6.07	2.04
		1994	2.49	2.99	4.44	-1.22	1.99	2.35	0.9	1.27	-1.46	3.8	0.46
Test Year		1995	2.86	2.87	2.96	1.34	2.39	2.48	21.81	5.47	3.74	-4.57	1.51
	2.0	Average	2.76	2.86	4.29	1.81	2.19	2.41	7.34	2.70	0.95	1.77	1.34
R97-1		1996	2.77	3.16	1.84	-2.61	1.95	2.56	-1.75	1.41	2.54	0.57	2.27
		1997	2.59	3.36	1.98	-0.64	3.07	2.84	-6.89	0.19	3.18	7.79	0.77
Test Year		1998	1.41	3.99	2.4	-2.96	2.71	3.15	2.73	-1.46	-10.23	0.59	-2.84
	1.0	Average	2.26	3.50	2.07	-2.07	2.58	2.85	-1.97	0.05	-1.50	2.98	0.07
R 2000-1		1999	1.9	3.56	2.48	1.75	3.54	3.25	-1.68	-1.35	-0.76	-1.64	-1.96
		2000	3.29	4.03	4.87	0.9	3.8	3.29	8.42	4.42	30.69	5.87	2.69
Test Year		2001	2.5	4.53	4.89	0.37	3.09	3.53	4.24	0.87	6.13	2.8	2.25
	2.5	Average	2.56	4.04	4.08	1.01	3.48	3.36	3.66	1.31	12.02	2.34	0.99

1/ Private Industry

Source: DRI USSIM/CONTROL0500
DRI CISSIM/TREND36YR0200
Actual CPI and PPI through March 2000
Actual ECI through 2000:Q1